MULTISTATE TAX COMMISSION ANNUAL MEETING
JULY 28, 2005

Discussion of Revisions to UDITPA

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I. Fundamental Philosophies/Constraints

a. The income of a multijurisidictionally integrated business is difficult--if not impossible--to specifically assign, either geographically or functionally. Because precision is not possible, rough approximation is sufficient.

b. State consideration or taxation of the income of a multijurisidictional business is subject to constitutional constraints – the Due Process Clause of the Fourteenth Amendment and the Commerce Clause. The "unitary business principle" is the constitutional touchstone.

c. There should be full accountability. All income should be assignable to someplace where it can be taxed. Actually, taxation may not be required, but from a policy perspective, it might be preferable.

d. The formula factors are not about what is being taxed, but are representative of activities that give rise to income. Therefore, not all activities need be reflected in an apportionment formula.

II. The Problem Areas in My Order of Significance

a. The Sales Factor

i. Sales of other than tangible property

1. These sales are now frequently the principal types of sales of many taxpayers. The sales factor is generally viewed as representing the "market." Therefore, income-producing activity is an inappropriate first assignment rule because it duplicates the property and payroll factors. It is not customer oriented.

2. Current UDITPA assigns these sales to the single state that has the greatest cost of performance. This all-or-nothing approach is also inappropriate.

3. One simple example of a more appropriate rule for the assignment of one type of receipt is the nonbusiness income rule for the assignment of patent and copyright income to the place of use.

4. The sales of other-than-tangible property does not have a throwback rule. Full accountability requires one.

5. The states that use only a sales factor to assign income may provide some guidance for the assignment of these sales in any context.

ii. A sales factor need not be all inclusive--the definition of sales should be modified.

1. A current example is the controversy that now exists as to whether the gross receipts from the short-term investment of liquid assets should be included in the sales factor and on what basis.

2. The MTC has a model regulation that defines sales. It could be used as a model for developing a more appropriate statement of what should be in the sales factor--perhaps sales.

3. If it is necessary to include all sales, then in some circumstances perhaps only the net amount should be included.

4. There have been recent efforts by taxpayers to attempt to "double count" sales. For example, a taxpayer obtains a receivable from the sale of its product and then sells the receivable to a third party and seeks to include the receipts from the sale of the receivable in the sales factor. This type of double counting should be written out of the statute. Other examples include the hedging of a commodity, or the swapping of fungible goods.

iii. Sales of tangible property

1. The question of where something is shipped or delivered has been an area of some controversy. "Dock sales" are an example. The location of the customer should be controlling in most cases.

2. Should sales to the United States government be treated differently than other sales?

3. Where should sales of tangible property be assigned when there are additions or modifications to the product while it is in transit to its ultimate destination? An example, Japanese autos are shipped to the United States. When they land in California, modifications are made or accessories are added. Is the sale a California sale, or should they be assigned to where they are ultimately destined?

4. What is the appropriate rule for a throwback assignment? UDITPA currently assigns such sales to the place from which the goods are shipped. This is not a market-oriented rule, but rather, is based on the place of the next closest connection. As long as full accountability is a goal, it appears there is a need for a throwback rule. Perhaps the need for a throwback rule could be eliminated if making sales is viewed as sufficient to create nexus.

5. The MTC regulations have a "double throwback" rule--is there a need for such a rule? The taxpayer sells goods manufactured by another. The taxpayer is not taxable in the state to which the goods are shipped, and is not taxable in the place from which they are shipped. Where should those sales be assigned?

b. What factors should be used and how should they be weighted?

   i. The United States Supreme Court has referred to the three-factor formula as "something of a benchmark." That is, the three-factor formula reflects in a rough sense how income is earned. But it has also accepted single-factor formulas. Prior to UDITPA, California, at one point in time, suggested six or seven different factors and gave the agency the ability to use additional ones.

      The use of multiple factors has the advantage of "averaging." Using a single factor may give rise to aberrational results for any one year. Also, the use of a particular factor might be appropriate for a particular line of business or activity but not another.

      Economists may have suggestions for other factors.

   ii. There is a trend to double weight the sales factor. There is theoretical support for double weighting sales in terms of "balancing" the contributions of production and market.

iii. The use of a single-factor sales formula is considerably more suspect. Payroll and property being the elements of production are more related to the cost of providing services that a state has. In addition, the rationale for a sales-factor-only formula is considered constitutionally suspect by a number of people.

iv. Efforts to achieve uniformity will require compromise on weighting, which suggests a need to at least double weight sales.

c. Business/Nonbusiness Income Determination

i. The use of the term "business income" and/or "nonbusiness income" by itself creates problems because sometimes these terms give rise to an inappropriate inference as to whether particular income should be apportioned or allocated.

ii. The states have had four or more decades of litigation on whether the current definition contains two parts, transactional and functional, or only describes transactional activity with a subset of functional activity. A number of courts have concluded there is but a single test. That conclusion has frequently given rise to legislative action to amend the statute. These efforts have sometimes given rise to one rule for in-state companies and a different rule for out-of-state companies. The better solution is to have one rule that includes both kinds of income.

iii. The suggestion that the definition be phrased in terms of the constitutional limits on state taxation does not appear to be a satisfactory solution to me. The very fact that constitutional limits are elastic and case driven, and therefore dependent upon the particular factual circumstances presented to the courts, means that they provide little real guidance to taxpayers or tax administrators.

iv. The most significant current example of this problem is the sale or liquidation of a line of business. The reasoning is that if a taxpayer is terminating a business, how can the results be business income? The argument is that by its very nature, the termination of a business is not transactional in nature, and therefore cannot be "business income." But the termination of a business is the final realization of the profits from the activity of the business. In many cases, it represents the recapture of expenses used to reduce business income in the past.

v. The efforts by courts to make a determination of apportionability on the basis of an occasional versus a regular transaction make little sense. Apportionable income should include both transactions in the regular course of the business, and transactions involving assets that have been accounted for and used in the regular course of business.

d. Property Factor

i. The exclusion of intangibles from the property factor has become increasingly difficult to justify as many businesses now derive the bulk of their income from the exploitation of intangibles.

ii. The biggest problem with respect to intangibles is determining their location. Assigning them to a single location does not make sense. They have value every place they are being used, and they should be proportionally assigned to those places. This suggests using the receipts or income they generate as a means of assignment.

iii. UDITPA uses historic cost-to-value property. This is a better choice than a tax basis since many assets have continuing value after they have been depreciated or amortized. Obviously, when assets are acquired at different times in the economic and inflationary cycles, historic cost does not provide a continuing accurate measure of the value to the business. Replacement cost might well provide a better measure if agreement can be reached as to how to determine that value.

iv. In many instances, a portion of a larger asset is excess capacity, and it is made available to others for a use unrelated to the primary business. Should efforts be made to remove this property from the property factor since it is not directly contributing to the business of the owner?

v. Businesses may have property located out of any taxing jurisdiction. Traditionally this was property on the high seas. Now we are dealing with extraterrestrial property. Should this property be left out of the factor, or should there be a method to assign it back to some jurisdiction?

e. Payroll Factor

i. The modern business world is outsourcing everything, including its work force. UDITPA includes only employees based upon traditional criteria. It would appear that there should be some

recognition of the contribution that "independent contractors" may make to the business. Is this a payroll equivalent?

ii. Even employees are now paid in a variety of ways. Do the payroll rules need to be re-evaluated to include other types of compensation, such as stock options?

iii. Does what a business pays its executive force fairly reflect their contributions to the business? Are these contributions reflected in the payroll at the appropriate time? Should a headcount be used or some type of weighted payroll?

iv. Public Law 86-272 allows a business to have employees within a state without incurring a liability for income taxes. Should there be a throwout rule for such employees?

v. UDITPA uses a single-state assignment rule for most employees. Is this realistic in our mobile age? To what state should an employee who teleworks be assigned? A more appropriate assignment of employees' salaries might be based upon time.

f. Section 18 – Relief

i. The current standard for variation is that the statutory rules "do not fairly reflect the activity within the state." Is this the right standard or should another standard be proposed? Arguably, this standard must be applied on a state-by-state basis. That type of application can give rise to non-uniformity.

Should the standard be one of constitutional distortion?

Would it be appropriate to establish a calculated threshold for a variance?

ii. Who has the burden of proof there is a need for a variance? It is generally viewed that UDITPA places the burden on whoever is seeking the variance, be it the taxpayer or the tax administrator. Is this appropriate?

iii. Is it only the unusual situation, or that which is not normal for that particular business, requiring a variance, or can a reoccurring event not fitting the standard formula justify a variance?

iv. There probably will always be a need to deal with taxpayer specific situations, but should section 18 relief be limited to those

situations? Should a state be allowed to use section 18 to provide industry variations?

v. Arguably, a state wherein an industry is based may have the best understanding of that industry, how it earns income, and what are the correct formula factors and how they should be assigned. Should there be a mechanism so that variations adopted by such a state become the model or norm for other states?

g. Assignment of Nonbusiness Income

i. UDITPA provides specific rules for the assignment of income for 1) rents and royalties from real and tangible personal property; 2) capital gains and losses from sales of real and tangible property; 3) interest and dividends; and 4) patent and copyright royalties. There are no rules for other types of income.

There should be rules for other types of income such as service income.

There should be a default rule for any type of income that is not specifically enumerated.

ii. The current rules should be reviewed for their appropriateness.

iii. Are special rules needed for partnerships and other pass-through entities? Should only capital gains or losses be dealt with or should it be any gains or losses?

h. Combined Reporting

i. About one-half of the states use combined reporting. It is generally accepted that combined reporting is one of the most effective tools to limit tax avoidance through the use of corporate entities. It has the blessing of the United States Supreme Court. Its application may require extensive factual inquiries to determine whether the relationship between commonly controlled entities warrants its application. It appears unlikely that consolidated filings on the basis of ownership would withstand a constitutional analysis. Combined reporting carries political baggage due to being represented as unfriendly to business.

ii. The determination of a "unitary business" for combined reporting is a judicially evolved standard, and efforts to articulate an objective standard have been difficult. Without a uniform standard using

objective criteria, it is not clear when endorsement of combined reporting by itself would give rise to uniformity.

iii. One of the controversial aspects of combined reporting is whether it should be applied on a worldwide or water's-edge basis. Worldwide combined reporting gives rise to attacks based upon the large variances that exist between the economies of the nations. If a water's-edge alternative is recommended, there are issues as to how to define the water's-edge.

iv. There are a number of special types of businesses that need to be considered. UDITPA excludes financial organizations and public utilities. Those businesses have become deregulated, and there appears less reason to exclude them from the combined report. There are other types of businesses, however, where exclusion may still be proper, such as insurance companies.

v. How should pass-through entities be dealt with in a combined report--proportionate or all-or-nothing?

vi. If combined reporting is adopted, there has to be agreement on a common apportionment formula so businesses that might otherwise use a different formula can proceed on a common basis.

For example, a number of states apportion the income of transportation companies on the basis of mileage. In a combined report, all of the entities need to use the same formula elements, such as property payroll and sales. Mileage could still be used, but it would have to be applied to the property and payroll engaged in interstate activities and to the sales arising from interstate transportation of goods in order that those values could be included in the apportionment formula with other types of entities.

vii. If combined reporting is to be adopted, there should be recognition of the fact that corporate taxpayers may have more than one unitary business and that different formulas may be required for the different businesses.

viii. If a corporate group engages in more than one unitary business, a method needs to be established for dividing up the income and expenses of any entity that participates in more than one business.

i. Nexus

   i. The debate continues in the courts as to whether nexus requires some type of physical presence or whether economic presence is sufficient. For Due Process purposes, it appears all that is required is purposeful availment of the market. This would appear to be a sound basis for taxability as well. However, for Commerce Clause purposes, where the question is the burden on commerce, something additional may be required. Including a standard within UDITPA should go along way to responding to burdensome complaints because 1) the minimum standard would be known and applied by everyone, and 2) the need for a throwback rule might be obviated, or at least it would be more clearly defined, thereby lessening the likelihood of multiple taxation and a burden on commerce.

   ii. One alternative that might be considered is what has been called factor presence. That is, if the taxpayer had a minimum amount of any one of the apportionment factors in the state, taxable nexus would exist. By establishing appropriate thresholds, complaints regarding the burden on small businesses could be addressed and de minimis activities, or the assessment of de minimis amounts of tax, would be avoided.

   iii. One issue that would need to be addressed in conjunction with combined reporting is whether nexus is determined on an entity basis or a unitary business basis--commonly referred to as the Finnigan/Joyce choice. If the premise of the combined report is that the method of organization should not affect the tax, then the Finnigan rule, nexus on the basis of the unitary business, is the appropriate standard.

   iv. Another issue to be addressed is whether nonbusiness activity could establish nexus or whether the taxability of one unitary business would establish nexus for another unitary business owned by the same interests.